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UNCLAS SECTION 01 OF 03 TAIPEI 002675

SIPDIS

SENSITIVE

STATE PLEASE PASS AIT/W AND USTR

STATE FOR EAP/RSP/TC, EAP/EP AND EB/IFD/OIA
USTR FOR SCOTT KI
USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT
TREASURY FOR OASIA/ZELIKOW AND WISNER
TREASURY PLEASE PASS TO OCC/AMCMAHON
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF
GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: N/A
TAGS: EINV EFIN ECON PINR TW
SUBJECT: RMB Appreciation No Help for Taiwan

Summary

¶1. (U) Because of Taiwan's massive investment in the PRC, the two economies cooperate more than compete in world export markets. Thus export orders to Taiwan firms will not benefit from a revaluation of the Renminbi (RMB). Although a revaluation could affect some investment decisions by Taiwan firms, high levels of Taiwan investment in the PRC are likely to continue. On balance, a revaluation of the RMB would not benefit Taiwan's exports to the PRC because most of them are inputs used to assemble consumer goods that are re-exported from the PRC. Overall the effect for Taiwan will probably be negligible. End summary.

Collaborators Not Competitors

¶2. (U) While many of the world's exporting economies stand to benefit from the anticipated revaluation of the PRC's Renminbi (RMB), which would make China's exports more expensive, Taiwan's situation is different from most. Taiwan and China are not competitors in international markets so much as collaborators. The cross-Strait economic dynamic is mainly one of cooperation with China serving as the factory for Taiwan's exporters. The predominant pattern is for Taiwan firms to move labor-intensive manufacturing processes to the Mainland, while maintaining technology and capital-intensive production of inputs in Taiwan. Taiwan-owned factories in the Mainland fill export orders received by headquarters in Taiwan using Taiwan-made components. In 2004, more than 70 percent of information technology products produced by Taiwan firms were manufactured in the PRC.

¶3. (U) Appreciation of the RMB would generally increase prices for exports of Taiwan firms. Even though many production inputs come from Taiwan and would become cheaper with the RMB appreciation, exports manufactured by Taiwan firms in China would still be more expensive because the RMB appreciation would increase the cost of locally sourced inputs, especially the labor component. As a result, export orders for Taiwan firms manufacturing their goods in the Mainland could fall. However, some observers point out that although Taiwan firms with operations in the Mainland will face higher production costs, they will also see the value of their Mainland investments rise. Most estimates put total Taiwan investment in the Mainland at USD 100 billion or more.

Marginal Change in Investment Strategies

¶4. (U) Because appreciation of the RMB will increase production costs in the Mainland and make it more expensive to invest there, some Taiwan firms may change their investment patterns. In the short run, some Taiwan manufacturers may shift some production from China back to Taiwan or to other locations. Some firms may reconsider or postpone relocation of production lines to China if production costs rise to levels comparable to costs in Taiwan. They may also choose to relocate to places other than China. However, many analysts expect any such reaction to be temporary with cost-cutting measures quickly restoring the full advantage of production in the Mainland.

¶5. (SBU) In the long run, RMB appreciation may not have much impact on Taiwan investment at all if past experience is an indicator. As Morgan Stanley (Taiwan) President Ho Chi-wen pointed out, the RMB gained 20% against the NTD from 1997 to 2002, but its appreciation never dampened the relocation of Taiwan's production lines to China. Taiwan approved USD 3.9 billion in PRC investment in 2002, more than double the USD

1.61 billion approved in 1997. Approved Taiwan investment in China continued to rise to USD 4.6 billion in 2003 and US$6.9 billion in 2004.

Trade Balance - Trends Continue

¶6. (U) The RMB appreciation will make imports cheaper in China and, therefore, could benefit foreign suppliers. However, Taiwan's exports to China are rarely consumer goods for local markets. Some estimates indicate that over 85 percent of Taiwan's exports to China are production inputs that are re-exported after further processing. The RMB appreciation will make the final products more expensive and could thus slow the pace or reduce Taiwan exports of inputs to the PRC.

¶7. (U) Theoretically, the RMB appreciation will make Taiwan imports from China more expensive and slow down the flow of imports from China. However, products from China could remain far cheaper than their Taiwan-made counterparts. It is likely that imports from China will continue increasing. The RMB appreciation of 20% against the NTD from 1997 to 2002 did not lead to any reduction in Taiwan's imports from China. Market liberalization required by Taiwan's and China's WTO accession prompted a sharp increase in Taiwan's imports. Taiwan imported USD 7.95 billion from the PRC in 2002, nearly double the USD 3.9 billion worth of PRC imports in 1997.

More Hot Money?

¶8. (SBU) Investor expectations that the RMB will revalue have already produced a large inflow of speculative capital (hot money) to China from all over the world. That flow will increase substantially if the PRC adopts gradual upward adjustment of the currency value. Such speculative money has begun to spill over to Taiwan with the expectation that currencies in the region will follow the RMB. For Taiwan, AIT/T contacts report an increase in advance payment for exports and a delay in payment for imports. Some additional hot money has flowed into Taiwan in the form of portfolio investment. However, the flows into Taiwan have not been enough to increase the money supply to a degree that would increase inflationary pressure. The capital inflow could well reverse once the RMB stabilizes after revaluation takes place.

Comment - Negligible Impact for Taiwan Economy
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¶9. (SBU) The net effect of an RMB appreciation for the Taiwan economy is likely to be negligible. A revaluation of the RMB would increase the price of PRC-produced goods. The dominant link between the two economies is Taiwan firms manufacturing products in the Mainland. Thus, increased production costs for the PRC would inevitably mean increased costs for Taiwan manufacturers. However, most analysts expect a fairly modest revaluation of the RMB, something on the order of ten percent. Financial markets have already adjusted prices with the expectation of this modest revaluation, as have Taiwan firms. Should the RMB revalue substantially more than what the market anticipates, then the impact on Taiwan will be greater and could dampen economic growth.

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